CHINESE WALLS IN LIGHT OF THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988*

*Napoleon J. Poblador***

I. INTRODUCTION, CHINESE WALLS AND CORPORATE GREED

A. *Insider Trading and Public Outrage*

Insider trading, which occurs when one buys or sells securities of a corporation on the basis of material inside information"[1] or "material nonpublic information,"[2] will be known decades from now as the scourge of the Roaring Eighties. It has blighted the securities market in a way that has tainted the arguably benign vice of corporate greed with Mephistophelean odiousness. Widely perceived as an ineluctable facet of the financial world, insider trading reached a level of banality which almost immuned it from public scrutiny and public outrage. Then came the stock market crash of October 19, 1987, corporate fiduciaries, taking unfair advantage of inside information,

*Seminar Term Paper submitted to Professors Haar and Meyer in fulfillment of the requirements in the subject Seminar: Mergers, Acquisitions and Corporate Restructuring, LL.M., Harvard Law School, 1989.

**LL.B. *cum laude* (1983), U.P. College of Law; LL.M. (1989), Harvard Law School, *Senior Partner*, Poblador Law Offices.

[1] R. CLARK, CORPORATE LAW 264 (1986).

[2] The term "material means that there is, as it is in the context of a proxy statement issued under section 14 of the Securities Exchange Act of 1934, a substantial likelihood that a reasonable shareholder would consider the fact of significance in making a decision. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). The term "nonpublic" means that the information on the basis traded is not available to the general public. *See* SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

managed to insulate themselves from the adverse effects of the crunch and in a few cases even enriched themselves at the expense of the countless small investors who were not similarly forewarned. This was followed by the filing of highly publicized cases against erstwhile reputable Wall Street figures and the resultant disclosure of the magnitude of insider trading and a re-examination of its adverse effects on the integrity of the securities market.

The rampancy of insider trading seems no longer in doubt. Empirical studies show that statutory insiders[3] invariably beat the securities market, consistently obtaining a much higher rate of return on their trading on their corporation's stocks than do public investors.[4] In the context of corporate takeovers, where the stocks of a corporation put in play can yield as much as thrice their purchase value, foreknowledge of a planned tender offer can ensure a windfall for insiders who trade on these stocks prior to the announcement of the tender offer. Studies indicate that the "run-up" in securities trading observed before a takeover announcement is ascribable to insider trading.[5]

More disquieting than the well-nigh endemic reach of insider trading is the involvement of multi-service securities firms in many of the high-profile insider trading cases. The most agregious among these cases occasioned the "largest probe ever" of a U.S. securities firm[6] and led to an unprecedented $650 million settlement with federal prosecutors who agreed not to file

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[3]"Statutory insiders" within the purview of section 16(a) of the Securities Exchange Act of 1934, are the directors, officers (president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer functions corresponding to those of such officers) and 10% beneficial owners of stock.

[4]*See* Baesel & Stein, *The Value of Information: Inferences From the Profitability of Insider Trading*, J. FIN. & QUAN. ANAL. 553 (1979).

[5]Bus. Wk., Aug. 24, 1987

[6]Drexel Burnham Lambert. This investment banking firm has a total capital of $2.3 billion. In 1986 alone, it earned $522 million. It almost single-handedly created the "junk bond" market which is now worth $180 billion. *See* Time Magazine, Jan. 2, 1989, at 84-85.

indictments for fraud and racketeering.[7] Public outrage over the implication of large multi-service securities firm coincided with Congressional exasperation with the "fundamental breakdown of the internal self-policing"[8] of these firms. One of these firms' "self-correcting mechanisms"[9] is the Chinese Wall.[10]

B. *The Chinese Wall In the Multi-Service Securities Firm: Reining In An Indomitable Hydra*

The quantum growth of the securities industry has seen the emergence of securities firm integrating and simultaneously discharging the various functions of investment adviser, investment manager, broker, dealer, investment banker and underwriter. In the performance of these functions, these multi-service firms incur legal obligations to various parties that are characteristically and necessarily conflicting. Where, for instance, inside information is obtained by the investment banking service of a multi-service firm from a corporate client and this firm's broker-dealer department has at the same time been engaged to make recommendations on the securities of that client by another client; the firm must reckon with three sets of conflicting obligations, to wit: (1) the duty owing to the first client to maintain the confidentiality of the inside information in question; (2) the duty owing to the second client to disclose that information to enable the latter to make a reasonable investment decision on the basis of all information then available from the firm; and (3) the duty under rule 10b-5, as construed by case law, to either disclose that

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[7] *Id.*, at 84.

[8] Herlihy, *Insider Trading and Chinese Walls: Is there a Need for Reform?* 561 CORP. L. & PRAC. COURSE HANDBOOK SERIES 727, 727 (1987).

[9] HOUSE COMM. ON ENERGY AND COMMERCE, INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H. REP. NO. 910, 100th Cong., 2d Sess. (hereinafter COMMITTEE REPORT), *reprinted in* 1304 Fed. Sec. L. Rep. (CCH) 14 (Sept. 21, 1988) (Part II).

[10] *See A Big Crack In the "Chinese Wall"*, Bus. Wk., March 2, 1987, at 33.

information or abstain from trading on, or recommending, the subject securities.[11]

Historically, it was the need to resolve this tripolar tension that justified the creation of the Chinese Wall. Subsequently, it also became a prophylactic, self-policing device employed by multi-service firms to complement the government's effort to curb insider trading. The Chinese Wall is a set of "internal written policies and procedures to control and prevent the dissemination of nonpublic information acquired by one department on a need-to-know basis to other separate departments within the organization"[12] of a multi-service firm. Quite commonly, the Chinese Wall takes the form of a proscription on internal communication between personnel of separate departments. Sometimes, it consists in the physical segregation of these departments. By effectively isolating one department from another, the Chinese Wall is supposed to stop the internal communication of inside information. Thus, the sales department may "continue to recommend the stock to customers," the research department may "continue to publish reports" and the trading arm may "continue to facilitate block transfers."[13] Skeptics, realizing that a completely non-porous Chinese Wall is no more real than the Chinese Blue Dragon, believe otherwise and have taken a more cautious, may even suspicious, view. Indeed, the Chinese Wall has

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[11]Lipton & Masur, *The Chinese Wall Solution To the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 464-466 (1975).

The duty of confidentiality owed by the investment banking firm to a client is predicated on the duty of an agent not to betray the trust of the principal by communicating to a third party information given to him by the principal in confidence. *See* Schein v. Chasen, 478 F. 2d 817 (2d Cir. 1973).

The "shingle-theory" cases support the proposition that a multi-service firm with inside information obtained by its investment banking arm might be duty bound to disclose that information to the clients of its broker-dealer arm on the theory that the firm, by putting out its "shingle" so to speak, as a broker-dealer, is presumed to have made an implied representation of fair dealing to said clients. *See* Lipton & Mazur, *supra*, at 465-466; Hanly v. SEC, 415 F. 2d 589 (2d Cir. 1969).

[12]Herlihy, *op. cit. supra* note 8 at 736.

[13]Kleinberg, *Restricted Lists and Chinese Walls*, 539 CORP. L. PRAC. COURSE HANDBOOK SERIES 649, 653 (1986).

been used to hide, rather than prevent, the shenanigans of unscrupulous arbitrageurs.[14]

The seeming imperfectibility of the Chinese Wall has brought to light what is inherently objectionable about multi-service firms in the first place: permitting a securities firm to do multiple and potentially conflicting functions promotes the kind of environment which makes the misuse of inside information not only possible, but extremely tempting as well. Where the different departments functionally overlap, as they typically do in practice, the question is not merely whether the Chinese Wall is effective in denying access to information in a way that will preclude its misuse, but also whether such access should at the outset be obviated by barring altogether the establishment of multi-service firms. The most extreme of the policy-oriented responses to the second question calls for forced segregation. The notoriety of insider trading and the proven or perceived complicity of multi-service firms have made it extremely difficult to ignore this response. In the bestiary of securities law violators, the multi-service firm is the multi-headed Hydra. As it must be with the mythical monstrosity, which can grow a new head just as fast as it takes to lop one off, it may be tempting to deal with the multi-service firm in the same expeditious manner, i.e., outright extirpation.

C. *The Insider Trading Act of 1988: Stoking the Beast*

Congress has resisted the temptation. In October, 1988 it passed H.R. 5133, otherwise known as the Insider Trading and Securities Fraud Enforcement Act of 1988[15] (hereinafter, Insider

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[14]Herlihy, *op.cit. supra* note 8 at 727.

[15]The Insider Trading Act of 1988 originated from a bill jointly introduced before Congress by the Committee on Energy and Commerce and Subcommittee on Telecommunications and Finance of the House of Representatives chaired, respectively, by John D. Dingell and Edward J. Markey, on August 2, 1988. The bill was unanimously approved by a vote of 410-0 as H.R. 5133 on September 14, 1988, and subsequently by the Senate by voice vote on October 21, 1988. The bill

Trading Act of 1988), prescribing *inter alia* the mandatory establishment of Chinese Walls in multi-service firms. A salient provision imposes an affirmative statutory duty on every broker, dealer and investment adviser to design and implement effective policies and procedures restricting the flow of confidential information from one department to another and, by this means, to check insider trading; another provision authorizes the Securities and Exchange Commission (hereinafter, the "SEC") to adopt rules or regulations reasonably designed to prevent the misuse of such information.[16]

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was transmitted to the Office of the President where it was finally signed into law on November 19, 1988.

[16]Sec. 3(b) Amendments Concerning Supervision--

> (1) Brokers and Dealers.--Section 15 of the Securities Exchange Act of 1934...is amended by adding at the end thereof the following new subsection:
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> "(f) Every registered broker or dealer shall establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this title (or the rules or regulations thereunder) of material, nonpublic information."
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> (2) Investment Advisers.--The Investment Advisers Act of 1940...is amended by adding after section 204 the following section:
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> "Sec. 204A. Every investment adviser subject to section 104 of this title shall establish, maintain and enforce written policies and procedures reasonably designed, taking into consider the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or by any person associated with such investment adviser. The Commission, as it deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse in violation of this Act

Congressional determination that the Chinese Wall can be a strong antidote to insider trading in multi-service firms does no more than confirm a long-held SEC bias in favor of this self-correcting device. While the new law exalts the SEC position, it far from forecloses the legal and policy questions that have made it controversial. A re-examination of the more important of these questions is thus in order.

II. THE INSIDER TRADING ACT OF 1988: CONGRESSIONAL ACCEPTANCE OF THE CHINESE WALL

A. *The SEC View of the Chinese Wall*

The SEC has been one of the strongest proponents of the Chinese Wall. It gave its official imprimatur in 1968 when, in an unprecedented policy move, it prevailed upon a multi-service firm to adopt a Chinese Wall in exchange for the withdrawal of the administrative charges it had brought against the latter whose brokerage arm, after receiving adverse inside information from a client tipped off its other clients who then were able to sell their securities prior to public disclosure of the information.[17]

Subsequently, the SEC defined the outermost limits of its official endorsement by ruling that it would regard as "suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information from its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his organization immediately or closely thereafter."[18] Mere possession, therefore, of inside

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or the Securities Exchange Act of 1934 (or the rules or regulations thereunder) of material, nonpublic information."

[17]*In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Rel. No. 34-8459, (1967-69 Transfer Binder) Fed. Sec. L. Rep. (CCH) +e77, 629 (1968).

[18]*In re* Investment Management C., Inc., Securities Exchange Act Rel. No. 34-9267, (1970-71 Transfer Binder) Fed. Sec. L. Re. (CCH) +e78, 163 at p. 80, 522 (1971).

information by one department, absent proof of internal communication to another department resulting to insider trading on the basis of such information, is neither conclusive nor dispositive of the multi-service firm's liability under rule 10b-5. The *onus probandum*, it seems, remains with one who asserts that inside information had in fact flowed through the interstices of the Chinese Wall.

The SEC's belief in the Chinese Wall remained steadfast even after the District Court in *Slade v. Shearson, Hammill & Co., Inc.*[19] invoking the strict "disclose or abstain" rule in the watershed case of *SEC v. Texas Gulf Sulphur Co.*,[20] rejected the defense raised by the defendant, a multi-service firm, when sued by a client of its retail sales department who allegedly incurred loss after trading on certain securities based on this department's recommendation which was given despite the fact that the investment banking arm had previously obtained adverse nonpublic information about the securities in question. The defense was to the effect that the Chinese Wall of the firm precluded the use of the information to suspend the solicitation of purchases by its retail sales department until after public disclosure. The case was elevated to the Second Circuit where it generated heated disputation, within and without the judicial forum, about the social value of the Chinese Wall in general. The issue presented struck at the very heart of the conundrum of conflicting duties, to wit: "Is an investment banker/securities broker who receives adverse material non-public information about an investment banking client precluded from soliciting customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?"[21] Well aware that the issue had "tremendous implications" for the securities industry, the Second Circuit ruled

[19](1973-74 Transfer Binder) Fed. Sec. L. Rep. (CCH) +e94, 329 (S.D.N.Y. 1974), *remanded*, 517 F. 2d 398 (2d Cir. 1974).

[20]401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[21]Slade v. Sharson, Hammill & Co., Inc., (1973-74 Transfer Binder) Fed. Sec. L. Rep. (CCH) +e94, 439 at 95, 531 (S.D.N.Y. 1974).

that the certification for interlocutory appeal was improper and remanded the case to the District Court, it being the "height of judicial folly...to attempt on an indeterminate factual record to make an abstract exposition that would adequately cover the various contexts and reach the proper overall results, however desirable this might be for the guidance of the business or however judicially challenging such an exposition might be."[22] The Second Circuit's trepidation was understandable. A finding that the conflict arising from the multiplicity of functions performed by a multi-service firm was irreconcilable could have socially disruptive implications. Indeed, the extremist view has been broached that forced segregation is an inevitable consequence of such a finding.[23]

None of the "tremendous implications" came to fruition because the issue formulated by the District Court was mooted by the supervening settlement of the case. This anti-climactic denouement did not, however, stop the SEC, appearing as *amicus curiae,* from clarifying its position on the Chinese Wall controversy. Arguing closely to the position it had as early as Merrill Lynch taken[24] in favor of the Chinese Wall, the SEC maintained that Shearson, by continuing to recommend the securities in question to innocent buyers without disclosing to them the adverse inside information, acted contrary to the representation which under the "shingle" theory it was deemed to have impliedly made that it knew the merchandise it recommended and had an "adequate basis" for the investment opinion it rendered.[25] The SEC then argued that conduct inconsistent with this implied representation gives rise to rule 10b-5 liability, constituting as it does a form of deception through silence. Nonetheless, the SEC insisted that the general duty flowing from this implied representation did not entitle Shearson's customers to be tipped off with inside information if the same had been isolated in the department which obtained it. The

[22]Slade v. Shearson, Hammill & Co., Inc., 517 F. 2d 398, 403 (2d Cir. 1974).

[23]*See* SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 72 (1936).

[24]*Merrill Lynch,* Fed. Sec. L. Rep. (CCH) +e77, 629.

[25]Hanly v. SEC, 415 F. 2d 589, 596 (2d Cir. 1969).

SEC concluded that Shearson could have avoided liability if it had in place a Chinese Wall reinforced with a no-recommendation policy under which the inclusion of a security in a restructured list triggered by the mêre fact of engagement of the firm's investment banking arm and prior to the actual receipt of any inside information would prevent the brokerage arm from making any recommendation or promote it to withdraw an outstanding one.[26]

B. *The SEC's Binary Approach: The Tandem of Regulation and Self-Regulation*

The SEC has stood for greater cooperation between the public and private sectors in curtailing the evil of insider trading. A scheme deriving strength from a combination of regulatory vigilance and the self-correcting capability of the securities industry is seen as allowing for the continued existence of multi-service firms. Although far from perfect, the Chinese Wall is a necessary fixture in this scheme. Acceptance of this self-policing measures is not only an act of faith; it is a concession to pragmatism as well. The Chinese Wall seems about the only effective alternative to mandatory segregation.

The SEC's rejection of the segregation solution is predicated on a couple of non-precedential arguments both of which paint a dim scenario of the putatively disastrous economic consequences of forced segregation. The main premise is that multi-service firms have grown immensely in size and number. They have become dominant players in the securities market. Many of the biggest securities firms offer integrated services. Although a few of the most prominent investment banking firms do not perform brokerage or dealership functions, their need for marketing clout has been predicted to spur diversification of functions in the near future.[27] Proceeding from this premise, the SEC figures that segregation will make for inefficiency because it will destroy the

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[26]*See* Brief for SEC as Amicus Curiae, Slade, 517 F. 2d 398.

[27]Robertson, *The Underwriters Have To Offer Even More*, FORTUNE, Jan. 1973, at 116.

economic-arising from the common information and research requirements of the brokerage and underwriting functions.[28] Moreover, segregation will lead to the withering away of the small multi-service firms whose viability has depended on the combined profits from all their services. The disappearance of these small firms will ultimately undermine the orderliness and reduce the market liquidity of the securities market for small cooperations which traditionally have been serviced almost exclusively by the small multi-service firms.[29]

That these two economic arguments have influenced the conclusions reached by several Congressional inquiries does not detract from their largely "speculative"[30] nature. Analogical or anecdotal evidence might be available to confirm the argument that segregation will eliminate economies. But this argument appears trivial when set against the greater danger posed by the continued existence of multi-service firms the conflicting duties concomitant to which create a public perception of unfairness and self-dealing. This perception can drive investors away from the securities market. In consequence, the economy would be hampered in its ability to rapidly re-allocate capital resources to areas of economic endeavor where they are needed.

The feared effects of segregation on the liquidity of the securities market for small corporations do not also lend themselves to empirical proof. Like, perhaps, the eschatological argument posited to prove the existence of life after death, verification is impossible except by effecting forced segregation and observing how the securities market actually behaves. Considering the stakes involved, essaying such a try-and-miss approach seems fool-hardy at best. Moreover, that the large multi-service firms are not presently disposed to enter the underwriting market for small

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[28]Notes, *Conflicting Duties of Brokerage Firms*, 88 HARV. L. REV. 396, 409-410 (1974), *citing* SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1, at 432 (1963).

[29]*Id.*, at 410.

[30]*Id.*

corporations does not indicate how they would behave if the small-service firms are eliminated by segregation. The dynamics of the free market are such that, generally, supply tends to eventually catch up with demand. Considering the hefty size of the securities market for small corporations, the profit incentive should be able to sway the large multi-service firms into filling up the vacuum.

There is another reason why the argument for segregation has been given short shrift by both the SEC and Congress. A Draconian solution mandating the involuntary dismemberment of services performing conflicting functions will trigger a state of disequilibrium, perhaps of catastrophic proportions, by forcing large multi-service firms to sell or spin off highly profitable departments. Divestment will undercut their power in the securities industry. During this period of dislocation, the securities market, stirred by uncertainty, could plunge to a state of greater entropy. Propelled by self-interest, the large multi-service firms will be expected to enlist a powerful lobby in Congress to stave off the enactment of any pro-segregation bill. The political argument has been raised only recently in connection with insider trading regulation.[31] But further inquiry along this line should yield enlightening insights on the SEC's consistent espousal of the merits of the Chinese Wall.

Between the Scylla of compulsory segregation and the Charybdis of insider trading, the SEC has taken pains to negotiate a route that gives equal berth to both. Taking the pragmatist's view, it has adopted a binary approach that calls for "increased regulatory and self-regulatory vigilance".[32] Its effectivity depends on cooperation between the government and the private sector--the former providing its criminalizing authority and the full panoply of its coercive powers, the latter employing the self-correcting mechanisms by which it polices its own ranks. Congressional action against insider trading has been governed by the same

[31]Macey, *From Judicial Solutions to Political Solutions: The New Directions of the Rules Against Insider Trading*, 39 ALA. L. REV. 355 (Winter 1988).

[32]Notes, *supra* note 28, at note 86 of p. 410.

thinking. The House Committee on Energy and Commerce has clarified that

> (t)he war against insider trading must be fought on many fronts. Consequently, in the view of the Committee there are a variety of statutory measure which should be implemented to enhance our enforcement framework, irrespective of the level of (SEC) resources.
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> The Committee has hoped that the self-correcting mechanisms of the marketplace and greater awareness among the self-regulating organizations (SROs) and the firms themselves would curb abuses in the securities market without need for legislation.[33]

Without the private complement, the war against insider trading will exhaust the man-hours and resources of the SEC. Also, "(a)bandonment of the system of self-regulation could lead to the creation of a governmental bureaucracy that might even lessen the effectiveness of regulation."[34] It is possible that in the face of an indifferent private sector, the government would overreact to every clever refinement in the methods used by insiders in securing and employing inside information by resorting to more stringent regulation which could ultimately have a chilling effect on the securities market.

C. *The Chinese Wall and the Insider Trading Act of 1988*

The Insider Trading Act of 1988 is the Congressional Response[35] to five principal concerns. Firstly, the efforts of governmental agencies, notably the SEC, to detect and investigate insider trading have been hampered by lack of resources.[36] Secondly, there is a real need for greater cooperation on the part of the private sector in the adoption of self-correcting mechanisms, like the Chinese Wall, to stem market abuses.[37] Thirdly, the

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[33]COMMITTEE REPORT, *supra* note 9, at 14.
[34]Herlihy, *supra* note 8, at 768.
[35]*See* note 4 Macey, *supra* note 32, at 355-357.
[36]COMMITTEE REPORT, *supra* note 9, at 14.
[37]*Id* ., at 14.

involvement of multi-service firms in recent insider trading cases betrays the inadequacy of existing Chinese Walls in these firms.[38] Fourthly, the "sophisticated and secretive" nature of insider trading calls for the award of bounty payments to informants and whistle-blowers.[39] Lastly, existing fines and penalties lack deterrence.[40]

The sense in Congress is that success in the war against insider trading is "crucial to the capital formation process that depends on investor confidence in the fairness and integrity of our securities market,"[41] that "insider trading damages the legitimacy of the capital market and diminishes the public's faith,"[42] that the "investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the issuer of such securities,"[43] and that the "small investor will be" and has been "reluctant to invest in the market if he feels that it is rigged against him."[44]

The new law does not define insider trading for two reasons. For one thing, "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition would potentially be narrowing, and in an unintended manner facilitate schemes to evade the law."[45] For another, Congress "does not believe that the lack of consensus over the proper delineation of an

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[38]*Id.*, at 15.
[39]*Id.*, at 15.
[40]*Id.*, at 16.
[41]COMMITTEE REPORT, *supra* note 9, at 8.
[42]*Id.*
[43]*Id.*
[44]*Id.* For a more comprehensive discussion of the "fairness" argument see Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Law*, 93 HARV. L. REV. 322 (1979). The theory that insider trading is a positive form of behaviour is discussed in H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).
[45]*Id.* at 11.

insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation."[46]

The legislative intent not to change the topography of existing case law on what constitutes insider trading implies that the ruling in *Dirks*[47] will render liable a multi-service firm whose brokerage arm continues to recommend the purchase or sale of securities on the basis of adverse favorable inside information obtained by its other departments, unless an effective Chinese Wall is in place to actually prevent the internal communication of that information. Thus, in order to escape the reach of the *Dirks* ruling, the multi-service firm must comply with the "affirmative duty"[48] the new bill seeks to impose upon it to "establish, maintain, and enforce written policies and procedures reasonably designed...to prevent the misuse in violation (of the law) of material, nonpublic information."[49] If the multi-service firm "knowingly or recklessly failed" to do so, and such failure "substantially contributed to or permitted the occurrence of the act or acts constituting the violation," it shall be liable and shall suffer civil penalties.[50]

While the adoption of a Chinese Wall is imposed as an affirmative statutory duty, the penalty prescribed for non-compliance applies only in the context of an actual violation amounting to insider trading. Therefore, a multi-service firm does not incur liability merely on the basis of its failure or refusal to adopt a Chinese Wall. On the other hand, where the firm has an effectively functioning Chinese Wall, its liability for insider trading will depend on the situation. If the firm itself is the tipper, as

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[46]*Id.*

[47]*Dirks*, 463 U.S. 646 (1983).

[48]COMMITTEE REPORT, *supra* note 9, at 18.

[49]*See* note 16.

[50]Subsection 3(b) (1) (B) of the Insider Trading Act of 1988 provides that "(n)o controlling person shall be subject to a penalty under subsection (a) (1) (B) unless the Commission established that...such controlling person knowingly or recklessly failed to establish, maintain or enforce any policy or procedure required under section 15(f) of this title or section 204A of the Investment Advisers Act of 1940 and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.

when its board of directors directs an employee to tip another person, it shall be liable for the penalty.[51] If the internal communication is the *ultra vires* act of the employee, the latter's liability will not be imputable to the employing firm automatically,[52] but will depend on the existence and adequacy of the Chinese Wall. In this situation the new bill will regard the firm as a "controlling person"[53] with regard to the peccant employee. Consequently, the firm will be liable only if the following conditions obtain, to wit: (1) knowing or reckless failure to establish, maintain or enforce the Chinese Wall or any similar policy or procedure; and (2) the fact that such failure substantially contributed to or permitted the occurrence of the violation.

The law does not define the terms "knowing" or "reckless", but the Congressional intent is to require that the firm "objectively disregarded a risk that a controlled person was engaged in violations of the insider trading laws" and that the "risk involved must be such that to disregard it would constitute a gross deviation from the standard of care that a reasonable person would exercise in such a situation."[54]

Neither does the law define the phrase "substantially contributed to or permitted the occurrence of the act or acts constituting the violation." The legislative intent, however, is clear that liability will attach where the failure "allowed the violation to occur, or that it provided some assistance to the controlled person's violations.[55] The standard which requires proof "that but for the

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[51]*See* note 8 of COMMITTEE REPORT, *supra* note 9, at 17.

[52]Subsection 3(b)(2) provides that "(n)o person shall be subject to a penalty under subsection (a) solely by reason of employing another person who is subject to a penalty under such subsection, unless such employing person is liable as a controlling person under paragraph (1) of this subsection...."

[53]Although the term "controlling person" is not defined by the proposed law, the legislative intent is clear that, as interpreted by the courts, it includes "any person with power to influence or control the direction or the management, policies, or activities of another person." *See* COMMITTEE REPORT, *supra* note 9, at 17.

[54]COMMITTEE REPORT, *supra* note 9, at 18.

[55]*Id.*

controlled person's breach the violation would not have occurred" was rejected.[56]

The Insider Trading Act of 1988 is also noteworthy for the breadth of the quasi-legislative authority it delegates to the SEC. It provides that the SEC, "as (the latter) deems necessary or appropriate in the public interest or for the protection of investors, shall adopt rules or regulations to require specific policies or procedures reasonably designed to prevent misuse of material, nonpublic information."[57] The vagueness of these rule-making standards cannot but provoke ambivalent reactions.

On the one hand, the latitude it affords the SEC in dealing with insider trading in multi-service firms ensures flexibility in coping with the increasing creativity and sophistication of securities law violators. On the other hand, giving the SEC virtually free rein, with reasonableness, public interest and investor protection as the only standards, will allow the SEC to propane its favored device, the Chinese Wall reinforced with the recommendation policy. The arguments raised against the non-recommendation policy, as the heated debate in *Slade* succeeded in focusing, suggest a more gingerly attitude toward any ancillary mechanism which calls for the suspension of the activities in one department, like the commencement of a fiduciary business relationship with a client or the actual receipt from this client of material, nonpublic information. One concern that has been grossly underestimated is the one over the fact that the no-recommendation policy involves the use of a restricted list. According to the SEC's scheme, once a client engages the services of the investment banking arm of a multi-service firm, this client's securities shall immediately be included in a restricted list--published, continually updated and circulated throughout all the other departments--even prior to the actual receipt of any material, nonpublic information from the investment banking client. Thereupon, the brokerage arm shall be precluded from making any

[56] *Id.*
[57] *See* note 16.

trading recommendation respecting these securities and shall withdraw any such outstanding recommendations. The mere fact, however, of being listed might prove to be as much revealing an unwitting tip as a deliberate enterprising arbitrageurs, using a combination of common sense, gum-shoe acuity and the venality of many fiduciaries, can transform the fact that a particular company has been listed into a whole welter of information about, for example, a planned tender offer. It is a rather naive view to regard the no-recommendation policy, as some academics and policy analysts seem disposed to do,[58] as a sort of secondary wall that can stop the leak of inside information after the Chinese Wall has been breached. A re-examination of this view is in order. Congress, in this connection, might have wisely acted in refusing to dip its fingers into the heated controversy. Instead of prescribing a set of specific policies and procedures, it chose to direct the SEC to conduct a more thorough study of this problem as part of the SEC's mandate under the new bill.[59]

The remaining feature of the Insider Trading Act of 1988 that is germane to the subject *ad rem* is its implication on the "shingle" theory. *Hanly* enunciated the rule that one who presents himself or holds out his shingle as a securities broker impliedly represents to his customer that he has reasonable basis for his recommendations, which should include the input of all information in his possession necessary to support a rational investment decision.[60] The broker, therefore, would be liable to a customer who incurs loss by trading on a security because the broker failed or chose to withhold material, nonpublic information. This rule cannot survive in the context of a multi-service firm with a statutorily imposed Chinese Wall. If the new law had been in effect at the time the factual situation in *Slade* arose, the District Court would have certainly not rejected the argument of the

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[58]Chazen, *Reinforcing the Chinese Wall: A Response*, 51 N.Y.U. L. REV. 552, 556-557 (1976); Notes, *supra* note 28, at 412-413.

[59]Subsection 5(b) (2), The Insider Trading Act of 1988, COMMITTEE REPORT, *supra* note 9, at 5.

[60]*Hanly*, 415 F. 2d 589 (2d Cir. 1969).

defendant therein that the Chinese Wall precluded it from making any recommendation on the basis of the inside information.

III. CONCLUSION

Insider trading is nothing less than a putative evil. Efficient market theorists, using pro-Coasian arguments, may continue to extol the supposed virtues of regulatory abstinence, but there can be no denying the fact that a state of affairs which enables a person, taking unfair advantage of information not available to others, to profit at the latter's expense, offends the basic notion of fairplay which holds civilized society together. That, briefly put, is what the war against insider trading is all about.

That Congress has been willing to match its awareness of the magnitude of insider trading with the political will needed to deal with it is evidenced by the passage of the Insider Trading Act of 1988. After all, the public has caught a glimpse of the adversary and has felt the sting of its virulence. It is well that the Executive Department, in approving the enactment, saw it fit not to do a reprise of the same "masterly inactivity" with which President Coolidge in 1927 reacted to the perorations of Harvard economics professor William Z. Ripley against the "prestidigitation, double-shuffling, honey-fugling, horn-swoggling and skullduggery of Wall Street."[61]

Congressional acceptance of the Chinese Wall reflects a policy of pragmatism that rejects the segregation solution as potentially disruptive and dovetails with the binary approach of the SEC, which complements regulation with self-regulation, in its war against insider trading, particularly in the context of a multi-service securities firm. However, the SEC's endorsement of a modified Chinese Wall buttressed by a no-recommendation policy elicits two contrasting reactions. The first is a favorable one,

[61] D. Vagts, BASIC CORPORATION LAW 168 (1989), quoting W. White, A. PURITAN IN BABYLON 338 (1939).

arising from the expedient manner in which Congress has chosen to deal with the "shingle" theory. The second is not, based as it is on the serious concern expressed over the unintended effects of the no-recommendation policy. Far from providing a second line of defense against insider trading, the no-recommendation policy might in fact facilitate it. The SEC's endorsement of this device should, therefore, merit reconsideration, especially in view of the wide discretionary powers granted the SEC in determining the self-correcting mechanisms a multi-service securities firm is mandated to adopt and implement, as well as the directive for the SEC to conduct more studies on the most effective ways to fight insider trading.

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